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# TAX REFORM

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## A STAFF STUDY

PREPARED FOR THE USE OF THE

## SUBCOMMITTEE ON ECONOMIC GOALS AND INTERGOVERNMENTAL POLICY

OF THE

## JOINT ECONOMIC COMMITTEE
## CONGRESS OF THE UNITED STATES

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## LETTER OF TRANSMITTAL

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NOVEMBER 26, 1984.

Hon. ROGER W. JEPSEN,
*Chairman, Joint Economic Committee,*
*Congress of the United States,*
*Washington, DC.*

DEAR MR. CHAIRMAN: I am pleased to transmit herewith a staff study entitled "Tax Reform" which was prepared for the use of the Subcommittee on Economic Goals and Intergovernmental Policy by William Buechner. I believe it will be of use to the Members of the Joint Economic Committee.

Sincerely,

LEE H. HAMILTON,
*Chairman, Subcommittee on Economic Goals and Intergovernmental Policy.*

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# TAX REFORM

## INTRODUCTION

In recent years, the Federal income tax has come under increasing attack from taxpayers, businessmen, and professional economists who believe its problems have grown so serious they can no longer be solved simply by tinkering with individual provisions in the tax code. Complete and comprehensive reform of the income tax, with all the problems cleaned up at the same time, has become the only reasonable way of improving the system. Tax reform will be one of the mos important issues facing the 99th Congress.

On Monday, November 26, the Treasury Department submitted a tax simplification plan to President Reagan, as he requested during his January 1984 State of the Union Message. This plan may form the core of any tax reform legislation submitted to Congress by President Reagan. In addition, during the 98th Congress, almost two dozen comprehensive tax reform bills were introduced. Academics and trade associations have also fielded tax reform plans. Each of these plans entails a different approach to tax reform, but all promise a complete overhaul of the existing system.

This increased interest in comprehensive tax reform has occurred because, by virtually every criterion, our tax system falls short. It fails to raise enough revenues to fund the government. It is riddled with unjustifiable deductions, exclusions, credits, and other preferences that erode the tax base while making the tax code

incomprehensible to the vast majority of taxpayers. It distorts investment decisions, causing billions of dollars to be wasted in unproductive tax shelters while pressing capital needs go unmet. It violates all the principles of tax fairness. It has become a source of economic instability and an impediment to intelligent personal and business planning.

In addition to broad agreement that the income tax should be thoroughly revised, a consensus is developing on the right kind of tax reform. Virtually all of the major tax reform proposals would broaden the tax base by eliminating most of the existing deductions, exclusions, and credits while at the same time reducing marginal tax rates. Most aim at revenue neutrality, though some taxpayers would pay more and some less. The differences fall into four main areas:

* The choice of the tax base, with some proponents of reform advocating that the base should be consumption rather than income;

* The degree of rate progressivity, with proposals ranging from a straight flat tax to a simplified progressive tax;

* The treatment of details, with proposals differing over the list of deductions to retain and eliminate, how to treat capital gains and losses, whether to retain indexation of the zero-bracket amount and the tax brackets, whether to permit indexation of capital basis and interest rates, how to treat depreciation of capital, and whether to change deductions into credits; and

* Taxation of corporate income, with some reform advocates suggesting that the corporate income tax be eliminated by integrating it with the personal income tax.

This study will address these issues in two steps.

First, it will develop the reasons why we should replace our present complex and inequitable tax system with a simplified progressive income tax that would broaden the tax base and reduce tax rates. Second, it will present recommendations for handling some of the detailed problems that will be encountered in designing an appropriate simplified progressive income tax.

Although there are a number of tax reform proposals, three have merited the most serious attention:

* The Fair tax (H.R. 3271, S. 1421), introduced by Senator Bill Bradley and Congressman Richard Gephardt. This is a broad-based income tax with a progressive rate structure and a top marginal tax rate of 30 percent. It would retain and reform the corporate income tax.

* The Fair And Simple (FAST) tax (H.R. 6165, S. 2948), introduced by Congressman Jack Kemp and Senator Bob Kasten. This is also a broad-based income tax, but with a single 25 percent flat tax rate. It is a mildly progressive tax, however, because it increases the standard deduction and the personal exemption and exempts 20 percent of earned income up to about $40,000. It would also retain a separate tax on corporate income.

* The Treasury Department's tax simplification proposal. This would resemble the Fair tax in that it would broaden the base and incorporate a simplified progressive rate structure, but with a top marginal tax rate of 35 percent. It differs from the Fair and FAST tax proposals mainly in the list of tax preferences that would be repealed or limited and in the treatment of indexing. The corporate profits tax would be retained and revised, but would be partially integrated with the personal income tax.

All three of these proposals are simplified progressive income taxes that differ primarily in degree of progressivity and the details of how taxable income would be computed. The Fair tax and the FAST tax have been widely analyzed and, with selected changes, either could constitute a significant improvement over the present Federal income tax. The Treasury proposal follows the same broad outlines as the Fair and FAST tax proposals, but certain specific provisions in the proposal could pose serious problems.

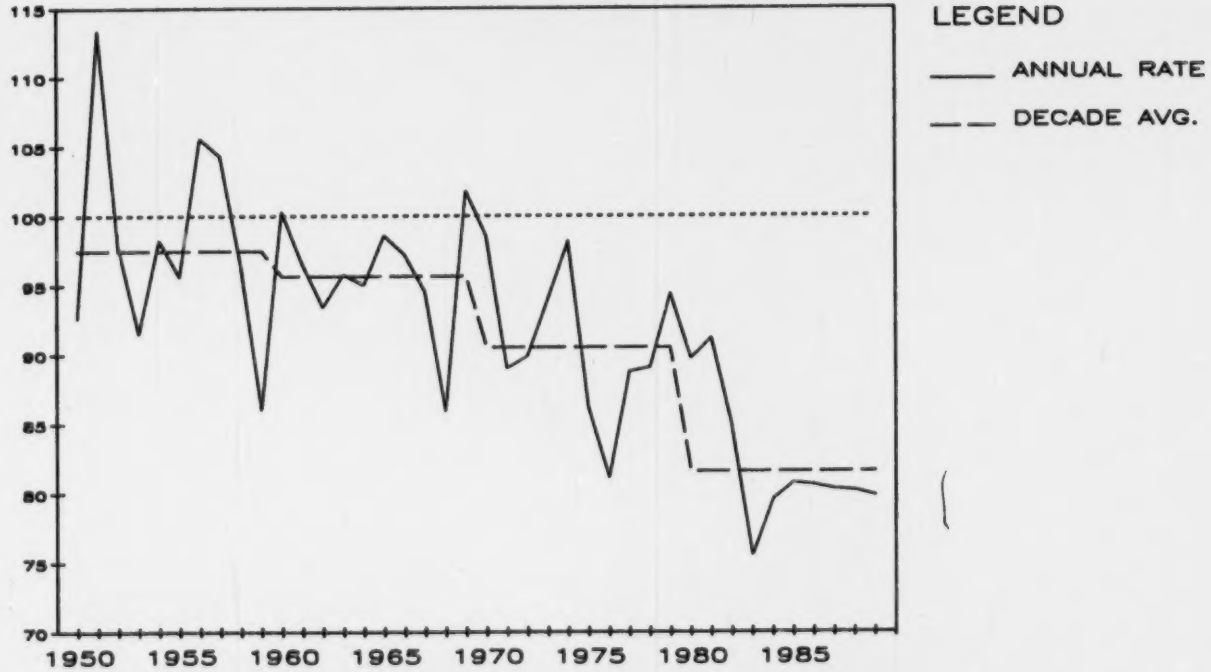
## THE PRINCIPLES OF TAX REFORM

The present income tax is held in such disrepute because it violates virtually every principle of taxation. Although it would be naive to suggest that tax reform legislation could escape the pressures that have pummeled the present tax system, any new tax system that disregards basic tax principles would likely be as bad as the current one. The following principles should form an adequate basis for judging among the different approaches to tax reform:

Revenues -- The main purpose of the tax system is to generate the revenues needed to finance the legitimate activities of the Federal Government.

Our current tax system falls far short of meeting this goal. According to the most recent figures from the Office of Management and Budget (OMB), we will have deficits in the range of $190 billion to $210 billion per year into the indefinite future, even with continued strong growth.1/ This is a disturbing break with the past. Until recently, the tax system successfully funded the Federal Government. As Chart I shows, tax revenues came to 97.5 percent of Federal spending during the 1950's and 95.6 percent during the 1960's. In the 1970's, the overall revenue/spending ratio fell to 90.7 percent -- a significant decline but one largely attributable to the major recessions during the Nixon and Ford Administrations.

## CHART 1
## FEDERAL RECEIPTS
## AS A PERCENT OF OUTLAYS
## 1950 TO 1989




Source: 1947-1983: 1984 Economic Report of the President, Table B-73, p. 306.
1984-1989: Congressional Budget Office, Economic and Budget Outlook: An Update, August 1984, Table III-2, p. 56.

Even though the revenue-raising goal of taxation was gradually eroded by other goals following World War II, the view was still widely accepted through the 1970's that, at least in years of relatively full employment, the government should be funded primarily by tax revenues. All previous postwar Administrations have accepted the fact that the Federal Government must run a deficit during recessions, with the revenue gap filled by Treasury borrowing the needed funds in the private credit market. These deficits, however, have always been considered temporary, to be reduced and eliminated as the economy recovered and resumed its normal growth.

With the proposal and enactment of the Economic Recovery Tax Act of 1981 (ERTA), however, this Administration officially abandoned the goal of funding the government through tax revenues in favor of the view that the incentive effects of taxation should take precedence over revenue needs. As a result, even after accounting for the revenues raised by enactment of the Tax Reform Act of 1984, taxes will fund only 80 percent of spending from Fiscal 1985 onward, as Chart I shows. This represents a permanent 20 percent revenue shortfall. Despite the hope expressed by President Reagan during the fall election campaign that growth would eliminate the deficit, even OMB now admits that huge deficits will persist year after year unless we make fundamental changes in tax and spending policies. Some fraction of the deficit can be erased by cutting spending. But, as OMB Director David Stockman has said, spending has been cut to the bone.2/ A major part of any serious attempt to reduce the revenue shortfall will require an increase in taxes.

Unfortunately, the three major tax reform proposals were all designed to be revenue neutral, generating no more revenues in 1985

than the present tax system. Although all three plans could yield more revenue growth in the future, since they would repeal a long list of deductions and exclusions that have been growing at a more rapid rate in recent years than has the tax base, none of the proposals would make a substantial improvement in the revenue shortfall. Generating adequate revenues should be an integral goal of tax reform, not a separate issue. All three major reform proposals thus need to be altered, either by further broadening the tax base or by incorporating slightly higher or more progressive tax rates.

Stabilization -- The Federal tax system should contribute to economic stability over the business cycle by cushioning cycle-related swings in consumer and business incomes.

Discretionary changes in fiscal and monetary policy can be powerful tools for improving economic performance during recessions or periods of high inflation, but discretionary policy measures take time to enact and implement -- a lag that can be filled by automatic stabilizers which act without the need for new legislation.

Until recently, the Federal income tax has acted as an automatic stabilizer because the rate structure is progressive. Tax revenues have usually declined more rapidly than incomes during recessions and have risen more rapidly during expansions, thus cushioning swings in disposable income. ERTA reduced the ability of the income tax to act as an automatic stabilizer by incorporating the proposal to index tax brackets for inflation. During upswings, the tax system will no longer act as a brake on inflation. In fact, the income tax may become a destabilizing influence, since the annual tax rate reduction will be larger with higher inflation.

The major tax reform proposals will be nominally less progressive than the present income tax, and so they will contribute less to economic stabilization over the business cycle. The FAST tax, with a single flat tax rate and indexing of exemptions, would be least stabilizing. The Fair tax, which eliminates indexing and has a progressive rate structure, would be most stabilizing.

Fairness -- The tax system should be a progressive one, with taxes levied on the basis of ability to pay. Taxpayers with equal incomes, regardless of source, should pay roughly equal taxes, while taxpayers with higher incomes should pay more tax than those with lower incomes.

More than 2,000 years ago, Plato wrote in Book 1 of The Republic: "When there is an income tax, the just man will pay more and the unjust less on the same amount of income." Recent polls indicate that Americans consider the Federal income tax to be the most unjust of all taxes.3/ This reflects the fact that many taxpayers, particularly the wealthy, pay less than their fair share of taxes because of their ability to use, and abuse, loopholes in the tax code that are not available to the average taxpayer. To be judged as fair, a tax system must meet two requirements. One is horizontal fairness -- taxpayers with the same ability to pay taxes should pay roughly the same amount of tax. The other is vertical fairness -- taxpayers with a greater ability to pay taxes should pay more tax.

Just over 70 years ago, we made the income tax the core of our tax system, reflecting the widely held belief that income is the best measure of ability to pay taxes. It is not ideal, since people with the same income may have different financial obligations and thus may differ in their ability to pay taxes. But the income tax recognizes

this by permitting certain deductions -- such as the zero-bracket amount and the personal exemptions, the deductions for catastrophic medical and casualty expenses, and the deduction for costs incurred in earning an income -- to assure that the tax burden is not distributed unfairly. With these allowances, tax fairness requires that those with equal incomes, regardless of the source, pay approximately the same amount of tax.

For the past 70 years, we as a Nation have also been solidly committed to progressive taxation, holding that wealthier taxpayers should pay a higher fraction of their income in taxes than their less fortunate counterparts down the income scale.

Although one argument for the progressive income tax is to reduce the inequality of income distribution, the most powerful reason for progressive taxation is that those with the highest incomes receive the greatest benefits from our system of stable government and free enterprise and thus should contribute the most to its support and preservation. Individual incomes are based primarily on ability to produce. But no one would be able to fully exercise his or her ability to earn income if the Federal Government did not fulfill its responsibilities to preserve free enterprise, keep us safe from foreign enemies, enforce contracts and prevent crime, develop a nationwide system of transportation and communications, encourage education, stabilize the economy, and regulate trade both within the United States and with foreign countries. By permitting those with special abilities to earn as much as they can, the government confers a blessing that must be paid for. As William Jennings Bryan said to the Democratic National Convention in 1896:

> The income tax is just. It simply intends to put the burdens of government on the backs of the people. I am in favor of an income tax. When I find a man who is not willing to bear his share of the burdens of the government which protects him, I find a man who is unworthy to enjoy the blessings of a government like ours.

The degree of progressivity is a matter of personal preference. Few, however, would disagree with the principle of progressive taxation.

Our present income tax, for all its other faults, is progressive. As Table I shows, the average tax burden rises with income. For example, in 1982, the average tax paid by those with adjusted gross incomes (AGI's) of less than $5,000 came to 2.8 percent of income, while those with AGI's of $1,000,000 or more paid an average of 39.3 percent. Taxpayers in between paid intermediate but rising amounts.

TABLE I

AVERAGE TAX RATES BY INCOME CLASS
1981-1982

| Size Of Adjusted Gross Income | Filers With Income Tax Liability: Average Tax (Whole Dollars) 1981 (1) | Average Tax (Whole Dollars) 1982 (2) | Tax As Percent Of Adjusted Gross Income 1981 (3) | Tax As Percent Of Adjusted Gross Income 1982 (4) | Percent Of Filers With No Income Tax Liability 1982 (5) |
|---|---|---|---|---|---|
| TOTAL | $ 3,703 | $ 3,604 | 16.5% | 15.4% | 19.2% |
| Less than $1,000 | 8,626* | 9,298* | -- | -- | 99.6 |
| $ 1,000 under $ 3,000 | 123 | 92 | 6.0 | 5.0 | 95.0 |
| $ 3,000 under $ 5,000 | 120 | 117 | 2.9 | 2.8 | 41.9 |
| $ 5,000 under $ 7,000 | 357 | 321 | 5.9 | 5.4 | 31.4 |
| $ 7,000 under $ 9,000 | 571 | 521 | 7.1 | 6.5 | 20.7 |
| $ 9,000 under $ 11,000 | 834 | 746 | 8.3 | 7.4 | 6.8 |
| $ 11,000 under $ 13,000 | 1,160 | 1,026 | 9.7 | 8.6 | 4.0 |
| $ 13,000 under $ 15,000 | 1,498 | 1,324 | 10.7 | 9.5 | 2.3 |
| $ 15,000 under $ 17,000 | 1,830 | 1,665 | 11.5 | 10.4 | 1.5 |
| $ 17,000 under $ 19,000 M | 2,179 | 2,001 | 12.1 | 11.1 | 1.8 |
| $ 19,000 under $ 22,000 | 2,645 | 2,399 | 12.9 | 11.7 | 1.2 |
| $ 22,000 under $ 25,000 | 3,209 | 2,956 | 13.7 | 12.6 | 1.3 |
| $ 25,000 under $ 30,000 | 3,976 | 3,676 | 14.5 | 13.4 | 0.6 |
| $ 30,000 under $ 35,000 | 5,103 | 4,605 | 15.7 | 14.2 | 0.5 |
| $ 35,000 under $ 40,000 | 6,370 | 5,743 | 17.1 | 15.4 | 0.5 |
| $ 40,000 under $ 50,000 | 8,379 | 7,468 | 18.9 | 16.9 | 0.5 |
| $ 50,000 under $ 75,000 | 13,050 | 11,803 | 22.2 | 20.1 | 0.5 |
| $ 75,000 under $ 100,000 | 22,867 | 20,865 | 26.8 | 24.5 | 0.4 |
| $ 100,000 under $ 150,000 | 36,828 | 33,321 | 30.9 | 27.9 | 0.2 |
| $ 150,000 under $ 200,000 | 58,439 | 54,447 | 34.2 | 31.8 | 0.5 |
| $ 200,000 under $ 300,000 | 88,930 | 82,400 | 37.2 | 34.3 | 0.2 |
| $ 300,000 under $ 500,000 | 149,990 | 135,233 | 40.1 | 36.2 | 0.1 |
| $ 500,000 under $1,000,000 | 278,182 | 252,751 | 41.8 | 37.8 | 0.1 |
| $1,000,000 or more | 925,655 | 877,132 | 44.0 | 39.3 | 0.1 |

* For many taxpayers at this level, includes amounts of additional tax for tax preferences.

M = Median taxpayer.

Source: U.S. Department of the Treasury, Internal Revenue Service. Statistics of Income Bulletin, Fall 1984, p. 73.

In other ways, however, the Federal income tax does not measure up to the basic principles of tax fairness. Because of the many deductions, credits, and exclusions in the tax code, it is quite possible for taxpayers with the same incomes to pay widely varying amounts of tax. Furthermore, tax preferences let some taxpayers with high AGI's face lower tax rates than other taxpayers further down the income scale.4/ In fact, in every income group -- even among those with AGI's in excess of $1,000,000 -- there were some taxpayers in 1982 who paid no tax, as Table I shows.

The main source of tax inequity is the long list of preferences that are not available to all taxpayers on even terms. The Joint Committee on Taxation lists 108 deductions, credits, exemptions, and other preferences in the tax code, including those affecting corporations, that can be used to shelter income from taxes.5/ This is double the number -- 53 -- listed in 1970.6/ Many tax preferences, particularly those which reduce the rate of tax on capital income, primarily benefit those at the top of the income scale. In addition, according to the Joint Committee on Taxation, the benefits of even the most widely used itemized deductions are concentrated among those earning $30,000 or more.7/

Prior to 1981, tax reduction bills sought to concentrate the benefits among lower-income and middle-income taxpayers. The Revenue Act of 1971 did this by increasing the standard deduction and the personal exemption. The Tax Reduction Act of 1975 raised the low-income allowance and established a 10 percent earned income credit for low-income families.8/ By contrast, ERTA sought to give the largest tax cut to upper-income taxpayers. Although all tax rates were reduced 23 percent over three years, the largest dollar benefit went

to those at the top, as Table I shows. In 1982, median taxpayers, with an AGI between $17,000 and $19,000, received an average tax cut of $178. By contrast, the 8,408 wealthiest taxpayers, with AGI's of $1,000,000 or more, received an average $48,523 tax cut -- an amount in excess of the AGI of 95 percent of all taxpayers. Between 1980 and 1982, the average tax liability of those with incomes over $1,000,000 fell by more than $122,000.9/

The major tax reform proposals are all less progressive in nominal terms than the present income tax. The FAST tax incorporates a single 25 percent tax rate that would apply to all taxable income, while the Fair tax has three rate brackets and a top marginal rate of 30 percent. The Treasury tax simplification plan would also have three rate brackets, but a top marginal tax rate of 35 percent. Although the Treasury plan is nominally more progressive than the Fair tax, with a top rate of 35 percent versus 30 percent for the Fair tax, the overall distribution of the tax burden for both plans will probably be similar since the Fair tax does a more thorough job of closing loopholes and broadening the tax base than does the Treasury plan. Both would retain the Nation's commitment to a progressive income tax while still reducing tax rates.

The FAST tax, despite a flat tax rate, would still be progressive although not as progressive as the Fair tax. First, the proposal would increase the personal exemption and zero-bracket amount. Second, it would exempt 20 percent of wage income up to $40,000, yielding an effective marginal tax rate of only 20 percent on the first $40,000 of earned income. Thus, over the low-income and middle-income ranges, the tax burden would gradually rise from zero to 25 percent. The wage exemption would be gradually phased out for those

making more than $40,000, so the marginal tax rate would actually rise to about 28 percent for those making up to about $100,000 where it levels off at a flat 25 percent.

The vast majority of middle-income taxpayers would pay no more tax under the Fair tax than they do at present, according to the Joint Committee on Taxation. Unlike most flat tax proposals, there would be no redistribution of the tax burden from upper-income taxpayers onto those in the middle. Almost 70 percent of all taxpayers, most of whom take the standard deduction rather than itemize, would be taxed at the basic 14 percent tax rate and would actually receive a small tax cut. Those dependent on tax preferences would experience an increase but there would be no major shift of the tax burden among income classes under the Fair tax.

The Treasury plan has not been in circulation long enough to have undergone the kind of scrutiny applied to the Fair tax and so its effect on the middle class is unknown. According to the Treasury Department, the plan was designed so as not to alter the tax burden among income classes, although it would provide some relief to those below the official poverty level. Eighty percent of taxpayers should experience no increase in their tax burden and many may receive tax cuts. If the Treasury's proposal does shift the burden onto the middle class, the rate structure and various specific provisions would have to be altered to prevent this.

The FAST tax, unfortunately, would shift some of the tax burden onto middle-class taxpayers. According to the Joint Committee on Taxation, those making over $100,000 would on average pay less tax under the FAST tax than at present. Those at the bottom would also

pay less than at present because the higher personal exemption and the wage exemption would permit families making under $14,000 to pay no Federal income tax. More of the tax burden would thus have to be borne by middle-income taxpayers. Following the massive tax cuts enjoyed by the wealthy under the Economic Recovery Tax Act in 1981, it is not likely that middle-class taxpayers would look favorably on another measure that put even more of the tax burden on their shoulders. The progressive rate structure of the Fair tax and possibly the Treasury plan would thus result in a more equitable distribution of the tax burden than the flat rate of the FAST tax.

There is, however, nothing sacred about the existing tax distribution. The need to raise revenues will require that at least some taxpayers pay more tax than at present. Keeping the current distribution means all taxpayers will face a higher tax burden. There is no reason why the added revenues should not come primarily from those at the top, since they have received the largest tax decreases since 1981. Under all three plans, this could be accomplished by adding another marginal rate bracket which would be higher than currently proposed but still significantly lower than the present top rate of 50 percent. The progressivity of the income tax would be improved while preserving the benefits of lower tax rates.

Efficiency -- The Federal tax system should interfere as little as possible in the allocation of resources. Tax preferences should be eliminated unless they serve an important national goal.

Most of the problems with our tax code can be traced to the fact that it has been decimated by a panoply of deductions, exclusions, and credits designed to alter economic behavior. These can be traced to

two broad motives. One is to stimulate savings and investment in order to enhance economic growth and productivity, leading to such tax preferences as the investment tax credit, the long-term capital gains exclusion, and the individual retirement account (IRA). The second is to channel resources into particular economic activities, giving rise to such preferences as the credit for energy-saving home improvements, the exclusion of interest on general obligation bonds, and the deduction for charitable contributions.

According to numerous studies, tax preferences can result in a waste of the Nation's resources, particularly by those which only serve the interests of specific industries rather than broad national interests. Ill-advised tax preferences also result in business and investment decisions being based on tax rather than economic consequences. The major tax reform proposals would make a significant improvement because they eliminate all but a handful of the preferences in the present income tax. No tax reform, however, can eliminate the influence of taxes on decisionmaking. The best we can do is adopt a system which minimizes such interference except through those few preferences which serve important national goals.

Simplicity -- The personal income tax should be understandable by the individual taxpayer.

For growing number of Americans, the income tax has become incomprehensible. In 1983, according to the Internal Revenue Service (IRS), professional tax preparers signed the returns of 37.2 million taxpayers -- all influenced by the fear they would miss deductions or pay too much tax if they did not consult a tax professional -- at a cost of more than $3 billion.10/ Tax preparation is also time-

consuming. One recent study found that the average American taxpayer needs about 21.7 hours to prepare state and Federal income taxes and to maintain necessary records, with actual preparation of the tax forms taking up about one-fifth of the total. With 97 million taxpayers, the total amount of time devoted to tax compliance comes to more than two billion hours per year.

The main culprit is the long list of deductions, exclusions, and credits that make it virtually impossible for the taxpayer to know whether or not he is paying the minimum legal tax or being treated fairly. This has become an increasingly important problem for two reasons. First, as incomes, mortgage interest, and state taxes have gone up in recent years, more people have been itemizing deductions. Second, each new tax bill has added new deductions or exclusions or closed up old loopholes with new rules that must be taken into account by taxpayers in computing their tax liabilities. Recently, IRA's were made available to all taxpayers with earned income, a deduction was enacted for married couples when both work, and a portion of social security benefits was made taxable for upper-income taxpayers. Each change requires additional computations that further increases the complexity of the tax code.

In recent testimony before the Joint Economic Committee, Congressman Richard Gephardt spelled out the implications of a tax system that has grown too complex:11/

> People sense that the law that we are living with today is unfair. And I think the worst part of it is that the American people feel their neighbors and their relatives and their friends are cheating at their expense. They're often right.
>
> I think they resent having to spend extra hard-earned dollars to hire a tax expert to guide them through what

> they think is the maze of our tax laws, and I think, as Senator Bradley said, we pay a heavy price for their mistrust.
>
> It creates compliance problems that we are all aware of. People increasingly believe that it's permissible, in fact necessary, to cheat to some extent and that everybody else is doing it and getting away with it.
>
> Not only does it make it more difficult for the government to raise the revenues required, but it makes it also harder for the government to accomplish anything in any area. And it's my belief that suspicions about the Tax Code translate into a general distrust and distaste for government.

The major tax reform proposals would reduce the complexity of the tax code for individuals by eliminating many of the special tax preferences. Nonetheless, simplification should not be carried to the point where it conflicts with other important goals of the tax system. Complex tax preferences that are available to only a limited number of taxpayers and serve only marginally useful purposes should be eliminated. But deductions and exclusions that are widely available and useful should be retained, including the deduction for interest on home mortgages, the charitable contribution deduction, the deduction for state and local income and real property taxes, the exclusion of interest on general obligation bonds, and a selected list of others that serve a useful social purpose or contribute to the fairness of the personal income tax. In his testimony before the Joint Economic Committee, Professor Musgrave explained the limits to tax simplification:12/

> The gains in simplification should not be exaggerated. The point is that even if deductions and exclusions were abolished, it would still be necessary to properly determine the taxpayer's net income, i.e., to determine which items should be included as cost of doing business, how costs such as depreciation should be measured, and how capital gains are to be determined. Broadening of the income tax base, while greatly desirable in terms of tax equity, should not be

confused, as it might be in the public mind, with the substitution of a tax on gross income. In all, simplification makes an important contribution but the primary gain from base broadening is in horizontal equity and the efficiency of the income tax.

Compliance -- The tax system should minimize the incentive and opportunity for taxpayers to evade taxation by underreporting income or overstating deductions and exemptions.

The growing frustration with the Federal tax system in recent years has lead to a disturbing increase in tax evasion. The Federal Government depends heavily on voluntary compliance to enforce the tax laws. Taxpayers -- both individuals and corporations -- report their own incomes and compute their own tax liabilities. If some taxpayers fail to report all their income or overstate deductions and exemptions, the result is a reduction in revenues and higher taxes for law-abiding taxpayers. It also means that some government resources have to be devoted to tax-law enforcement that could be put to better use elsewhere.

The revenue loss from tax evasion is significant and growing. In 1981, taxpayers failed to report $249.7 billion in legally earned income.13/ This cost the Federal Government $81.5 billion in lost revenues, according to the most recent study of taxpayer compliance by the IRS. Both figures are about triple the unreported income and revenue loss calculated by the IRS for 1973. Unreported income from illegal sources, including drugs, gambling, and prostitution, cost an additional $9 billion in lost tax revenues in 1981.

The IRS calculates that the amount of income reported by individual and corporate taxpayers declined from 91.2 percent in 1973 to 89.3 percent in 1981.14/ As Table II shows, the worst compliance

record belongs to taxpayers with income from capital such as dividends, interest, and capital gains, where the IRS has lacked a reliable means of verification. All three tax reform proposals could improve compliance in two ways -- by eliminating preferences that taxpayers can misuse to shelter income and by reducing tax rates to reduce the incentive to cheat. Should this fail to make a significant improvement in compliance, tax reform will have to be supplemented by increased enforcement.

TABLE II

VOLUNTARY REPORTING PERCENTAGES FOR INDIVIDUAL FILERS AND NONFILERS, BY SOURCE OF INCOME, 1973-1981

| Category | Percent of Income Reported | | | |
|---|---|---|---|---|
| | 1973 | 1976 | 1979 | 1981 |
| Wages and salaries | 95.4 | 94.9 | 94.4 | 93.9 |
| Dividends | 90.7 | 87.1 | 85.7 | 83.7 |
| Interest | 87.6 | 88.1 | 86.3 | 86.3 |
| Capital gains | 75.7 | 64.3 | 63.4 | 59.4 |
| Nonfarm proprietor income and partnership and small business corporation income | 84.0 | 82.2 | 80.7 | 78.7 |
| Farm proprietor income | 88.6 | 92.6 | 89.5 | 88.3 |
| Informal supplier income | 20.7 | 20.7 | 20.7 | 20.7 |
| Pensions and annuities | 81.5 | 85.3 | 85.0 | 85.2 |
| Rents | 94.7 | 94.0 | 95.4 | 95.6 |
| Royalties | 74.3 | 65.6 | 64.2 | 61.2 |
| Estate and trust income | 82.0 | 79.2 | 75.7 | 76.2 |
| State income tax refunds, alimony, and other income | 66.0 | 55.2 | 62.3 | 62.0 |
| Total income | 91.2 | 90.4 | 89.8 | 89.3 |

Source: Internal Revenue Service, Income Tax Compliance Research: Estimates for 1973-1981. Washington, D.C.: Internal Revenue Service, July 1983. p.10.

Federalism -- the Federal income tax should not impede the ability of state and local governments to raise the revenues needed to fulfill their responsibilities within our Federal system of government.

The Federal income tax currently permits taxpayers to deduct income, property, and sales taxes paid to other levels of government. The interest on bonds issued by state and local governments is also exempt from Federal income taxes. These provisions ease the burden of state and local finance on the individual taxpayer and help state and local government serve public needs. As Table III shows, the exclusion of interest on state and local bonds and the deduction for state and local taxes reduced Federal taxes for individuals and corporations by more than $50 billion in 1984. Under current policies, Federal tax support for state and local government finances will rise to $80 billion by 1988. Wholesale repeal of these tax provisions would create intense taxpayer pressure on state and local governments to cut spending and services or to seek more aid from the Federal Government. While the state and local tax deductions and interest exclusion make the tax code more complex and permit some taxpayers to pay less Federal tax than others, they serve an important national interest as long as we want strong state and local government.

TABLE III

FEDERAL TAX SUBSIDIES
FOR STATE AND LOCAL GOVERNMENTS1/
($ Millions)

| Tax Provision | Revenue Loss | | | | |
|---|---|---|---|---|---|
| | 1984 | 1985 | 1986 | 1987 | 1988 |
| Deductibility of nonbusiness state and local government taxes other than on owner-occupied homes | $19,840 | $21,635 | $25,510 | $28,690 | $32,030 |
| Exclusion of interest on general purpose state and local government debt | 11,510 | 12,995 | 14,560 | 16,160 | 17,800 |
| Deductibility of property tax on owner-occupied homes | 8,775 | 9,640 | 10,770 | 12,180 | 13,720 |
| Exclusion of interest on state and local government industrial development bonds | 3,400 | 3,865 | 4,470 | 5,000 | 5,130 |
| Exclusion of interest on state and local government housing bonds for owner-occupied homes | 1,785 | 1,820 | 1,775 | 1,755 | 1,750 |
| Exclusion of interest on state and local government bonds for pollution control and sewage and waste disposal facilities | 1,755 | 1,920 | 2,115 | 2,330 | 2,585 |
| Exclusion of interest on state and local government bonds for hospital facilities | 1,215 | 1,515 | 1,820 | 2,135 | 2,455 |

| Tax Provision | Revenue Loss 1984 | 1985 | 1986 | 1987 | 1988 |
|---|---|---|---|---|---|
| Exclusion of interest on state and local government housing bonds for rental housing | 1,095 | 1,365 | 1,685 | 2,010 | 2,370 |
| Exclusion of interest on state and local government student loan bonds | 380 | 525 | 700 | 865 | 1,030 |
| Exclusion of interest on state and local government bonds for private educational facilities | 375 | 465 | 560 | 660 | 760 |
| Exclusion of interest on state and local government industrial development bonds for energy production facilities | 150 | 180 | 205 | 235 | 270 |
| Exclusion of interest on state and local government mass transit bonds | 110 | 125 | 120 | 110 | 125 |
| TOTAL | $50,390 | $56,050 | $64,290 | $72,130 | $80,025 |

1/ Includes tax savings for individuals and corporations.

Source: Joint Committee on Taxation. "Estimates of Federal Tax Expenditures for Fiscal Years 1984-1989." Washington, D.C.: U.S. Government Printing Office, November 9, 1984. Table 1, pp. 9-17.

The Fair tax would retain the present deductions for state and local income and real property taxes, while repealing the deduction for sales taxes. In addition, it would retain the exclusion for interest on general obligation bonds. Interest on bonds issued for other purposes would be taxable. The FAST tax would make the same changes as the Fair tax with one exception -- under the FAST tax, state and local income taxes would not be deductible. Both would thus continue limited use of the tax code to ease the revenue burdens on state and local governments.

The Treasury Department's tax simplification proposal would eliminate the current deductions for state and local income taxes, sales taxes, and property taxes. While this would simplify the process of computing Federal taxes, it would weaken our Federal system of government. A strong case can be made for retaining at least some of the current tax preferences designed to support state and local governments.

Predictability -- Changes in the tax code should be made infrequently in order to minimize disruption of decisionmaking by businesses and investors.

Since 1975, seven major tax bills have been enacted, each making significant changes in the tax code for both individuals and corporations. Congress also passed dozens of minor tax bills that made smaller changes in the code.15/ In the last decade, according to Professor Richard Cooper of Harvard University, we have added "nearly 1,800 pages of new legislation to the basic 1954 tax code (which itself took 929 pages), plus more than 4,000 pages of accompanying legislative history issued by Congress".16/

Frequent tax changes are disruptive because they divert attention from the economic consequences of business decisions to the tax consequences. As Professor Cooper points out:17/

> We have "reformed" the tax code on average every 15 months since 1976...The problem is that constant changes in the tax rules greatly complicate decisionmaking by individuals and businesses. No one makes a financial decision without thinking about the tax code, and almost annual changes in the code greatly disrupt the way people make these decisions. Instead of thinking about how to make their companies more efficient, high-level business people devote their attention to manipulating the next round of "tax reform" to their corporate advantage...It takes considerably longer than a year for people to adjust to a new tax law -- and it takes the government longer than that to understand how the public is responding and decide whether or not the new law is furthering its stated purpose...Clearly, there is something to be said for the adage: "Any old tax is a good tax".

Although ERTA included a three-year tax cut aimed at improving predictability, the resulting deficits required that additional major tax legislation be enacted in 1982 and again in 1984. Although President Reagan still clings to the hope that economic growth will solve the deficit problem, the truth is that only a fiscal policy change -- including a tax increase -- can cut the deficit. This threat of another major tax bill in 1985 -- the fourth in five years -- hangs like a dark cloud over investors. This problem of uncertainty will only be solved if tax reform addresses the deficit as well as the structural issues in the tax code. Going only part way will inevitably result in the need for further tax legislation and more uncertainty.

SHOULD WE ADOPT A CONSUMPTION TAX?

The growing recognition that the present Federal income tax is permeated with faults has led in recent years to proposals to replace the income tax with a consumption tax. It seems unlikely that Congress will consider a consumption tax during the 99th Congress, since the major tax reform proposals are simplified progressive income taxes. Many industry associations, however, have been lobbying for adoption of a consumption tax since it would reduce the tax burden on saving and investment. One option listed in the Treasury study is a value-added tax. If opposition from special interests skuttles the tax reform effort in the 99th Congress, some form of consumption tax may be revived as a way of raising revenues even without reform of the income tax.

In its purest form, a consumption tax system would compute the tax base by adding up all spendable cash received during the tax year and subtracting all savings. The difference is consumption, which would be taxed using either a flat or progressive rate structure.

The most fully articulated consumption tax is the Lifetime Income Tax proposed by Henry Aaron and Harvey Galper of the Brookings Institution, which would tax a person's lifetime income as it is consumed rather than as it is earned.18/ The basis of the tax would be comprehensive receipts less saving. Receipts would include all wages and salaries, rent, interest, profits, dividends, transfer payments, gifts received, and inheritances. Saving would include all payments into certain qualified accounts, purchases of stocks and bonds, and purchases of real estate. Just as saving would be deducted from income, withdrawals from savings would be added. All loans would

be included as receipts and all loan repayments, including principal and interest, would be deductible in computing the tax base. Inheritances and gifts received would be counted as receipts but if they were not consumed they would be just offset by an equal deduction for saving. End-of-lifetime wealth representing unexercised potential consumption of the taxpayer would be included in the tax base with an appropriate averaging provision. Thus, over the lifetime of the taxpayer, all income would be subject to taxation but only when it was consumed or when the taxpayer died. The Lifetime Income Tax would retain some features of the present income tax, including a standard deduction and personal exemptions to assure that no taxes would be levied on lower-income families, a progressive rate structure with a maximum rate of 32 percent on those with expenditures above $40,000 per year, and certain deductions to improve equity, including a deduction for large medical expenses and casualty losses. The consumption tax principle would also apply to corporations, which would calculate their tax base by adding up all receipts and deducting all business expenses, including investment in the year paid.

Two consumption tax proposals were introduced during the 98th Congress. The Progressive Consumption Tax (H.R. 5841) proposed by Congressman Heftel would implement the kind of consumption tax described by Aaron and Galper, except that the rate structure would be more progressive and it would not tax bequests as consumption by the deceased. The Broad-Based Enhanced Savings (BEST) Act (H.R. 6364, S. 3042), introduced by Senator Roth and Congressman Moore, resembles the Fair tax in that it is a broad-based income tax with a progressive rate structure. The major difference is that the BEST tax would establish a super savings account for financial assets. Contributions

of up to $10,000 per year for individuals and $20,000 for couples could be deducted from taxable income and earnings would be excluded from taxation, but any withdrawals would be included in taxable income.

All three of these proposals would represent a significant departure from the present income tax. Other less radical proposals would retain the income tax but supplement it with a more modest form of consumption tax, such as a value-added tax or a national sales tax or an expanded use of excise taxes.

The most frequently mentioned reason for adopting a consumption tax is that it would increase the incentive for taxpayers to save and invest. In recent years, personal saving has hovered around 6 percent or less of disposable income, well below the level in other industrial countries, particularly Japan. This low level of savings was considered a major policy problem during the late 1970's when poor productivity growth contributed to high inflation. Critics found much of the fault for low savings in the Federal income tax. First, they argued that high marginal tax rates reduce the after-tax rate of return to saving, particularly for those upper-income taxpayers who have the greatest ability to increase their savings. Second, they argued that taxes levied on nominal rather than real gains reduce the after-tax return to saving during periods of high inflation, both for individuals and corporations. Third, they argued that the separate corporate income tax results in double-taxation of dividends and thus raises the cost of equity capital for corporations.

Numerous changes have been made in the income tax during recent years to correct this perceived anti-saving bias: eligibility for

IRA's was expanded to include all wage-earners; the top 70 percent marginal tax rate on unearned income was reduced to 50 percent; the long-term capital gains exclusion was increased to 60 percent and the holding period was reduced to six months; and depreciation deductions were increased through adoption of the Accelerated Cost Recovery System (ACRS). Nonetheless, critics of the present income tax argue that, instead of encouraging saving through tax preferences, it could be done in a more comprehensive way by exempting all savings.

Whether or not the income tax is biased against saving is an empirical question that has not been satisfactorily answered. The academic research is ambiguous. One recent study concluded:19/

> There are two ways to raise the private component of national saving through budgetary actions without losing the benefits to a large deficit: (1) cut expenditures and reduce marginal tax rates on capital income without changing the budget surplus or deficit, or (2) restructure taxes to reduce marginal tax rates on capital income without lowering total government revenues. As pointed out in chapter 3, economists are very uncertain about the likely effect of such measures on private saving behavior. The net effect on saving is ambiguous from a theoretical perspective, and the empirical evidence is not convincing on either side of the issue.

The fact that total private-sector saving -- including corporate saving -- has been relatively stable since the early 1950's suggests that other factors may play a much more significant role in determining savings, including income, profits, the composition of the population, interest rates, the long-term economic outlook, and attitudes. There are good reasons for eliminating many of the existing tax preferences that favor some forms of saving and investment over others, but there is no compelling reason without stronger evidence for exempting all saving from taxation. The result

may simply be an unnecessary erosion of the tax base without any significant increase in the total amount saved and invested in the American economy.

More philosophically, advocates of a consumption tax hold that people should be taxed on the basis of what they take out of the economy in the form of consumption rather than what they put into it in terms of work and resources that earn income. The attractiveness of this argument for the wealthy should be self-evident. For the Nation, however, this philosophy threatens to undermine our commitment to a fair and progressive tax system which levies taxes on the basis of each individual's ability to pay. Under a consumption tax, those receiving the greatest benefit from our stable government and free enterprise system would no longer be called upon to shoulder their fair burden of support for the government and the system it protects. Instead, the highest-income families could shift the burden of taxation into middle-income and lower-income families by socking large fractions of their income into tax-exempt forms of saving. The vast majority of working Americans whose incomes are just sufficient to support their families would not be so advantaged. For them, a consumption tax would become an even greater burden than the current income tax, no matter how progressive the rate schedule might be. A consumption tax would be a giant step away from our national commitment to fair and progressive taxation.

Although a consumption tax might eliminate any theoretical anti-saving bias in the present income tax, it would introduce other even more pronounced distortions into the tax system. First, the tax base would be lower than under an income tax, so tax rates would have to be higher in order to raise the same amount of revenues. This would

increase the incentive for workers to demand compensation in the form of nontaxable fringe benefits and greatly increase the incentive to evade taxation by underreporting income. Second, a consumption tax would distort the flow of savings, because some forms of saving would be treated as consumption, and thus would be taxable, while other forms would be tax free. Orthodox consumption tax proposals would exempt only cash placed in savings accounts, stocks, bonds, and traditional investments. While these contribute to the growth of our country, so do savings that take less traditional forms, such as expenditures on education, research, child care, and health care. For these, it is impossible to draw the line between savings and consumption. Nonetheless, a tax system which rewards only financial savings will bias investors against forms of saving that may have an even higher payoff for the Nation. Third, a consumption tax would fall most heavily on taxpayers just when they are least capable of paying taxes. Students and the unemployed, who must often borrow just to maintain marginal living standards, would have to pay substantial taxes because borrowed funds would be fully included in cash receipts for the purpose of computing the consumption tax base. The elderly drawing down past savings would also be hit with a higher tax burden than under current law. Wealthy coupon-clippers and rentiers would face no such burden.

A consumption tax would also complicate taxation of bequests. The current tax system taxes large estates to prevent excessive accumulation of inherited wealth although much wealth, especially in smaller estates, is exempt. Under a consumption tax, wealth passed from generation to generation would permanently escape taxation so long as it was not consumed, thus permitting unlimited accumulation.

Furthermore, horizontal equity in the tax code would be violated, since taxpayers with equal lifetime incomes could pay unequal amounts of tax. Both problems require that bequests be taxed in full as consumption for the deceased. The recent history of estate taxation, which saw many changes designed to reduce estate taxes, suggests that Congress would have little sympathy for the proper taxation of bequests if a consumption tax were enacted.

Adoption of a consumption tax would raise a long list of other problems. It would require a complete change in recordkeeping for both individuals and businesses. A complex transition period would be required to prevent past savings that had been taxed once under the income tax from being taxed a second time when consumed. This would be a particularly serious problem for the elderly whose savings decisions were based on the assumption that they could consume from their assets without incurring any new tax liability. A consumption tax would also cause conflicts with other countries that still tax income. Thus, even though a consumption tax might be justified on theoretical terms, the realities of a consumption tax give no sensible reasons for jetisoning the progressive income tax.

Consumption tax advocates who believe that enactment of a broad-based consumption tax is impossible have suggested that some of the tax burden can still be shifted onto consumption by piggybacking a value-added tax or national sales tax onto the existing income tax. This kind of bilevel tax plan would satisfy the President's instruction that tax reform must be revenue-neutral, while still picking up additional revenue to reduce the deficit.

The main difference between a value-added tax and a national sales tax is in the way they would be collected. A national sales tax would be levied on goods and services at the time of final sale. A value-added tax would be levied at each stage of production, with each business computing its tax liability based on the difference between its total sales and its purchases from other businesses. In theory at least, the tax base would be identical for both, since the total value of sales to final consumers equals the total value added by producers. The only difference would be an administrative one.

Either tax could be a significant source of new revenues. According to a recent study by the Congressional Research Service (CRS), a broadly based national sales tax or value-added tax could have raised as much as $18.2 billion in 1984 for each one percentage point on the tax rate.20/ A 5 percent tax could thus raise about $90 billion in new revenues (and more in future years) without repealing or limiting the marginal tax rate cuts enacted in 1981. Indexing and ACRS could also be preserved.

Despite any advantages, there are major problems with a national sales tax and a value-added tax. First, both would be regressive and violate the principle of ability to pay. One 1977 study cited by CRS found that a 5 percent national sales tax would amount to 3.4 percent of AGI for taxpayers in the $5,000 to $10,000 range but only 2.4 percent of AGI for those with incomes in the $30,000 to $50,000 range.21/ A value-added tax would be similarly regressive. The regressivity of a national sales tax or a value-added tax could be reduced by exempting necessities or by providing a credit against the income tax that would phase out as income rises. Both expedients, however, would increase the complexity of the Federal tax system while

significantly reducing the potential revenue from imposing either of these taxes as a new addition to the tax code.

These taxes would also be highly vulnerable to special interests, particularly the value-added tax. Declining industries under pressure from foreign competitors will argue that an exemption from the value-added tax would enable them to compete more effectively and preserve domestic jobs. This would exempt the auto, machine tool, steel, leather, and textile industries. High-tech growth industries could also mount an attack, based on the argument that an exemption would permit them to keep ahead of incipient foreign competitors. All industries producing necessities could also argue for an exemption or reduced rate in order to reduce retail prices. A national sales tax would not be so vulnerable to special interests, since it is levied at the point of final sale rather than on the producer, but arguments could still be raised for preferential rates for selected goods or services. A value-added tax or national sales tax punctured with special exemptions or preferential rates would not only erode the revenue potential, it would also be perceived as unfair by those not receiving favored treatment.

Additional pressure would be mounted during a recession, since neither a value-added tax nor a national sales tax would provide relief to businesses during a downturn. Currently, businesses that lose money during a recession pay no profits tax. However, unless they shut down, they still generate value that would be subject to the value-added tax. Thus, even in a recession with no profits, they would continue to find themselves burdened by a liability for the value-added tax. It doesn't take much imagination to foresee that this would generate intense pressure on Congress to exempt companies

with no net income from the value-added tax. Again, a national sales tax would be less vulnerable to this kind of pressure. Nonetheless, because retail sales fluctuate less than incomes during a recession, neither of these taxes would contribute to the countercyclical stability of the economy.

In addition, both taxes would increase inflation. The Consumer Price Index (CPI) does not reflect increases in the income tax, but it does include increases in sales taxes. It would also reflect any price increase caused by adopting a value-added tax. This could touch off a new wage-price spiral that could only be controlled by monetary tightness and recession. Either tax would add a new level of complexity to the tax system that would require more paperwork and a new level of administration. Neither would do anything to make the tax system simpler. In fact, with a panoply of different rates for different industries or different products, the tax system would become even more complex.

In summary, neither a national sales tax nor a value-added tax is a good substitute for a simplified progressive income tax that raises adequate revenues.

## INCOME TAX REFORM -- SELECTED ISSUES

The three major proposals that could form the basis for tax reform in the 99th Congress -- the Bradley-Gephardt Fair tax, the Kemp-Kasten FAST tax and the Treasury tax simplification proposal -- all reject the notion that the tax base should be shifted from income to consumption. They are broad-based income tax systems that would repeal many of the exclusions, deductions, and credits in the current

tax code and replace the present progressive rate structure with either a single flat rate tax or a simplified progressive rate. A complete list of the changes proposed by the major tax plans is provided in the Appendix to this study.

Although the three tax proposals are broadly similar, there are specific differences. Some of the proposed changes, particularly those included in the Treasury proposal, would be a matter of concern and may not represent an improvement over the present system.

Limit On The Value Of Deductions -- Under present law, deductions and exemptions are taken at the margin against the last dollar of income. They are thus worth much more to upper-income taxpayers than to those at the bottom of the rate schedule. For example, a $1,000 deduction reduces tax liability by $500 for a taxpayer in the top 50 percent bracket but by only $110 for a taxpayer in the lowest 11 percent bracket. Preferences which are deductible at the margin are thus regressive, with the greatest benefit accruing to those at the top of the income scale. Past tax reform efforts have tried to replace deductions at the margin with credits in order to provide the same dollar benefit to all qualifying taxpayers regardless of their rate bracket. Few credits have made it into the tax system, however, and most of them are minor -- the residential energy credit, the credit for political contributions, the credit for the elderly, and the child care credit.

All three major tax reform proposals would address this inequity by repealing many deductions that are available primarily to upper-income taxpayers and by reducing the progressivity of the rate structure. This would narrow the difference in the value of

deductions between taxpayers at the top and bottom of the income scale. It would also reduce the amount of income that can be sheltered through deductions. The Treasury Department's tax simplification plan will continue, however, to allow taxpayers to take deductions at the margin against the last dollar of income so that, with three tax brackets and a top marginal rate of 35 pecent, deductions will continue to be more valuable to those in the top bracket than to those in the bottom bracket.

Both the Fair and FAST tax proposals would go much farther toward transforming deductions into credits. The FAST tax imposes a single flat 25 percent tax rate, so each $1,000 in deductions reduces tax liability by $250 for all taxpayers regardless of income. While the Fair tax has a progressive rate structure, deductions and exemptions could be claimed only against the basic 14 percent tax rate. Deductions could not be taken against the 12 percent and 16 percent surtax rates. Thus, the Fair tax would reduce each taxpayer's liability by $140 for every $1,000 in qualifying deductions. While both the Fair and FAST tax proposals effectively transform the remaining deductions into tax credits, the Fair tax does it without foregoing a progressive tax rate structure. This limitation also makes it possible for the Fair tax to raise as much revenue as the Treasury proposal with lower tax rates.

Capital Losses -- Present tax law permits net capital losses to be deducted from ordinary income, up to an annual limit of $3,000. Losses above that can be carried forward indefinitely. The annual limit on deductibility of capital losses prevents taxpayers from manipulating their assets for the sole purpose of reducing taxable income. If there were no limit on capital loss deductions, taxpayers

holding large amounts of depreciated assets could realize their losses, deduct the full loss against ordinary income, and repurchase the asset after the appropriate waiting period, ending up with the same list of assets and a reduced tax liability. Since the bulk of financial assets are owned by the top 2 percent of families, according to the Federal Reserve,22/ full deductibility of capital losses would be a significant new tax loophole for upper-income taxpayers. One tax expert estimates that this could cost the Federal Government as much as $4 billion annually in lost revenues.23/

The loss limit should be retained in comprehensive tax reform. We do not yet know whether the Treasury Department's tax simplification plan will propose to alter the treatment of capital losses. The FAST tax, unfortunately, would allow unlimited capital loss deductions and thus would permit upper-income taxpayers to manipulate their wealth for tax purposes. The Fair tax retains present law treatment of capital losses.

Depreciation -- In computing taxable income, businesses should be permitted to depreciate the cost of plant, equipment, and other productive assets over their useful economic lives in such a way that taxable income accurately reflects economic profits. The present tax code fails to do this. Currently, depreciation is limited to historic cost -- i.e., the dollar cost of building a factory or the purchase price of a machine or other equipment. During periods of low inflation, historic cost depreciation is an adequate convention since it substantially reflects replacement cost as well. During periods of high inflation, however, historic cost depreciation is inadequate since it does not reflect full replacement cost, and taxable income will exceed economic profit. This raises business profit tax

liabilities and reduces the expected after-tax profits on investments, thus discouraging investment.

The present ACRS shortens depreciation for tax purposes significantly below expected economic lives for virtually all business assets, in the hope that the tax benefits from early cost recovery will offset the impact of inflation on replacement costs. ACRS, however, does not uniformly shorten depreciation shedules for all assets and, as a result, some kinds of capital are now highly subsidized by the tax code while others bear a significant tax burden. These tax-induced distortions waste capital.

Of possible solutions, the fewest economic distortions would be created by a depreciation system which permitted businesses to write off the replacement cost of plant and equipment over their useful economic life. This could be done either by indexing the historic cost to an accepted capital cost index, thereby adjusting depreciation charges annually for inflation, or by discounting the anticipated annual depreciation charges and writing off the present value of the charges in the year of purchase.

The Fair tax would replace ACRS with a new method based on historic cost recovery. Under the Fair tax, equipment would be divided into six classes based on the Asset Depreciation Range (ADR) lives. For example, all assets with an ADR midpoint of under five years would be placed in an asset class that would be fully depreciated over four years. Other assets would be placed in other classes, as given in the following chart:

| ADR Midpoint | Class Life |
|---|---|
| Under 5 | 4 |
| 5.0 to 8.5 | 6 |
| 9.0 to 14.5 | 10 |
| 15 to 24 | 18 |
| 25 to 35 | 28 |
| Over 35 and structures | 40 |

An open-ended account would be established for each asset class and each year the taxpayer would write off a percentage of the balance in each account based on the class life and the 250 percent declining balance method. Additions to each account would be made each year for purchases of assets in that class. Subtractions would be made for dispositions of assets and for that year's depreciation deduction. Structures would be put into the sixth asset class.

This system would be much simpler than the current one since individual assets would not have to be tracked for tax purposes. It would also eliminate the current ACRS subsidy of specific assets. Nonetheless, because it is designed to approximate the present value of economic depreciation at a 10 percent discount rate, it overstates economic depreciation at low inflation rates and understates it at high inflation rates for all asset classes.

The basic depreciation system in the Fair tax could be improved by indexing the value of each asset class annually for the increase in capital prices and then permitting each class to be written off using the straight-line depreciation method. This would preserve the simplicity of the asset class innovation, keep the system unbiased among assets of different economic lives, and provide an adequate correction for inflation.

The FAST tax would retain the ACRS depreciation system and thus would make no improvement over the current practice. Furthermore, for assets that are very long lived and which can change ownership, such as a factory or apartment building, the FAST tax permits full indexing of the basis in computing capital gains. When combined with ACRS, this provides a double subsidy.

The Treasury tax simplification plan would replace ACRS with a depreciation schedule that more closely conforms to economic lives. In addition, it will permit indexing of the depreciation schedules for inflation. Although special interests may protest the repeal of ACRS, it appears that the indexing provision could solve the problem of inadequate depreciation. Subject to further study, the indexing provisions in the Treasury plan could be melded with the asset class innovation in the Fair tax to provide a fair, efficient, and simple depreciation system.

All three tax proposals would repeal the investment tax credit. In periods of strong growth, the investment tax credit is a waste of money, since it rewards businesses for making investments they would likely make even without the credit. The purpose of the investment tax credit when first enacted in 1964 was to stimulate the growth of the economy by providing an incentive for business investment during a period of slack demand. It was never intended to be a permanent feature of the tax code. The investment tax credit should be repealed, although it could still be implemented occasionally during a recession or period of slow growth as part of an overall policy of fiscal stimulus.

Integration of the Corporate Income Tax -- Since 1909, the United States has levied a tax on corporation profits. Even though the corporate income tax is even more ancient than the personal income tax, it suffers many of the same problems and needs reform just as badly. The basic problem is the erosion of the tax base resulting from numerous special tax breaks that have been enacted over the years. Today, the amount of corporate income sheltered from taxation exceeds the amount actually taxed.24/ While the corporate profits tax is a significant source of Federal revenues -- $56.9 billion in Fiscal 1984 -- its contribution to receipts has slipped steadily from almost a quarter of the total during the early 1950's to just over 8.5 percent currently. The numerous special preferences in the corporate tax also misallocate resources. Investors guided more by tax consequences than economic consequences channel too many dollars into favored industries or types of capital and not enough into others. The economy suffers as a result from inadequate growth of productivity and industrial capacity. With many tax preferences designed to aid existing industries, the resulting misallocation of capital impairs the ability of young, high technology companies to compete in the world market against better financed foreign competitors. Finally, the fact that large billion-dollar corporations often pay no Federal tax because of special tax preferences has contributed significantly to the feeling among taxpayers that the income tax is unfair.25/

Both the Fair tax and the FAST tax would keep the corporate profits tax as a separate but integral part of the Federal tax system. Both would reform it by repealing many of the present tax preferences and by reducing the tax rate. The list of provisions that would be repealed or revised by the Fair tax is three pages long, including the

many preferences benefiting the oil, minerals, and timber industries, the investment tax credit, and the ACRS depreciation scheme. Broadening the base would permit the corporate tax to be reduced from the present 46 percent rate to 30 percent with no loss in total revenues. Corporate tax reform under the FAST tax would take much the same shape as under the Fair tax, although the investment preferences would be retained and smaller corporations would pay a reduced rate.

The Treasury Department's tax simplification plan would also broaden the base of the corporate income tax by repealing many tax preferences while reducing the tax rate to a flat 33 percent for all corporations. It would also go part of the way toward integrating the corporate income tax with the personal income tax by permitting corporations to deduct 50 percent of dividends paid when computing taxable income. Corporate tax integration has long been a goal of business-oriented tax reformers, who argue that eliminating the current double taxation of dividends -- once by the corporate profits tax and once by the personal income tax -- would lower the cost of equity capital and increase the incentive to invest.

Despite the theoretical attractions of corporate tax integration, there are compelling reasons to retain a separate tax on corporate profits. Proponents of integration argue that corporations are inseparable from their shareholder-owners and they should be taxed as one. Nonetheless, in legal terms, corporations and their shareholders are distinct. Unlike proprietorships, where the business is legally inseparable from the owner, shareholders have limited liability for the actions of the corporation and have only limited rights in the corporation. The special rights and protections granted to corporations require that they contribute their fair share, separately

from their shareholders, to the support of the government that grants those rights and protections.

The only consequence of interest in the taxation of corporate profits is an economic one -- whether or not the tax burden is too heavy -- and even there an argument can be made for a separate corporate profits tax. The corporate form of business organization permits a much greater accumulation of capital than any other form, because the investor's exposure is limited solely to the amount invested. This increased capital intensity permits corporations to achieve economies of scale and lower costs than would be possible under other forms of corporate governance. Large corporations also have greater control over their markets and can administer prices so as to achieve higher earnings. The enhanced earning power granted by the corporate form justifies a separate tax on corporate earnings. No matter what changes may be made in the personal income tax, tax reform efforts should retain the corporate profits tax, preferably as it would be revised under the Fair tax proposal.

Finally, the Treasury Department's proposal to allow a deduction for 50 percent of dividends paid would primarily benefit old-line manufacturing and service corporations while doing little to help smaller high-growth companies that plow all their earnings back into growth-producing investment. The major goal of corporate tax reform should be to reduce the waste caused by perverse tax incentives. The Treasury proposal would undermine this by channeling equity capital away from companies that reinvest their earnings into high future growth.

Indexation -- The Federal tax system levies taxes on income and gains measured in nominal terms. It makes no distinction between real increases in income or asset values and those due solely to inflation. Real gains pose no problem under the present tax code. A taxpayer receiving a wage increase during a period of zero inflation may move into a higher tax bracket. But, after paying the additional tax, he or she will still be better off. The same holds true for the seller of an asset whose real value has increased. The increase is subject to capital gains tax, but even after the tax is paid the seller earns a real gain.

When gains are solely due to inflation, however, the tax consequences can turn nominal gains into real losses. If a taxpayer whose income just keeps up with inflation moves into a higher tax bracket, the resulting tax increase will leave less real income than before. Of course, the taxpayer would still be better off than with no nominal increase, but worse off than if the increase had not been offset by inflation. The seller of an asset whose price has gone up but has gained no real increase in value after adjusting for inflation is, nonetheless, still liable for capital gains tax on the nominal increase, resulting in a real loss. Workers and owners of capital are both made worse off during periods of inflation by a tax system which levies tax on nominal rather than real gains.

The value of interest income is also affected by taxation in nominal terms. The nominal interest paid by a borrower to a lender includes two forms of compensation. One is the payment to the lender for foregoing the use of his or her funds, generally referred to as the real interest rate. The second is the compensation to the lender for the decrease in the value of the loan principle due to inflation.

The nominal interest rate on a loan thus includes the real interest rate desired by the lender plus the expected inflation rate. The entire amount of interest received by the lender, however, is taxable, even though some fraction of it simply represents compensation for the declining value of the loan.

During the high inflation of the late 1970's, many tax reform advocates suggested that the Federal tax system should be indexed for inflation to assure that taxes are levied only on real gains. Indexation generally incorporated three separate proposals:

* Annual indexation of tax brackets, personal exemptions, and the zero-bracket amount. Taxpayers experiencing nominal income gains just equal to inflation would thus be protected from moving into higher tax brackets.

* Indexation of asset basis for computing capital gains. The nominal increase in the value of an asset due solely to inflation would thus not be taxed, and the tax would apply only to the real gain.

* Annual indexation of interest income. Interest recipients would subtract the portion of their interest income which reflected compensation for inflation, and would thus be taxed only on their real interest income.

The Economic Recovery Tax Act of 1981 incorporated the first proposal. Beginning with 1985, tax brackets, personal exemptions, and the zero-bracket amount will be indexed to adjust for inflation during the previous fiscal year as measured by the CPI. For example, with inflation between September 1983 and September 1984 measuring 4.1

percent, the personal exemption will increase for 1985 from the present $1,000 to $1,040 for the taxpayer, spouse, and each dependent. The upper and lower boundaries for each tax bracket will also increase by 4.1 percent as will the zero-bracket amount.

The benefits from this kind of indexing would be substantially reduced by all three of the major tax reform proposals since they would replace the highly progressive tax rate structure of the present income tax with either a single flat tax or a simplified progressive rate structure with much broader brackets and lower rates. The Fair tax would repeal indexing, while the FAST tax would retain it for the personal exemptions and the zero-bracket amount. Under a simplified progressive rate structure, the benefits from indexing the tax brackets do not justify the costs, particularly in light of current revenue needs. Indexation is also destabilizing over the business cycle, with the largest tax reductions occuring during periods of highest inflation. Equity considerations, however, do suggest that if any part of the tax code is indexed it should be the zero-bracket amount. This would concentrate the benefits from tax indexing among low-income and middle-income families that do not itemize deductions.

The Treasury Department's tax simplification proposal also incorporates indexation of capital basis and interest income. This would create a major new tax preference in the tax code that is not needed under current economic conditions. The inflation rate has come down substantially since the late 1970's. While nominal gains and interest rates still exceed real gains and interest rates, the difference is no longer sufficient to pose an excessive burden on owners of capital assets. The much lower tax rates being proposed under the major reform plans would also reduce the tax burden levied

n incomes and gains in nominal terms. Furthermore, the single major asset for the vast majority of taxpayers -- their home -- is already protected by the rollover exclusion and the $125,000 exemption for sellers over 55 years old, both of which would be retained.

Indexation of the basis of assets for computing the capital gains tax and indexation of interest income would also require a substantial amount of new recordkeeping for those receiving these forms of income and would greatly increase the complexity of computing tax liability. Interest indexation involves one further problem. Corporations and individuals can currently deduct total interest payments in computing taxable income, including that portion of the payment which simply represents compensation to the lender for the reduction in the nominal value of the loan. If lenders are permitted to index interest receipts and pay tax only on real interest earnings, borrowers would also have to adjust their interest deductions. The net result would be a shift in the tax burden from lenders to borrowers. Such a change could not be implemented without a substantial transfer in wealth or a complex set of transition rules that would simply make the tax system all the more incomprehensible to the vast majority of taxpayers.

The final problem with indexation is that it would reduce opposition to inflation. Aside from the tax consequences, inflation imposes real costs on the economy. One benefit of a tax system which levies taxes on income and gains in nominal terms, even during periods of high inflation, is that it creates pressure on the government to control the inflation problem. Indexing makes it possible for taxpayers to adjust much more easily to inflation and would thus reduce the pressure to control it. While indexing relieves taxpayers

from the costs of inflation, it does nothing to reduce the economic harm.

Indexing should thus be used for only limited purposes. Indexing of the zero-bracket amount helps protect low-income and middle-income families from being hurt by inflation since they can least afford it. Indexing of depreciation would protect the tax system against schemes such as ACRS that create more problems than they solve. Indexing of capital basis and interest, by contrast, would greatly increase the complexity of the tax code and provide new opportunities for tax abuse.

FOOTNOTES

1. "White House Is Said to See Record Deficit of $205 Billion in Current Fiscal Year," Wall Street Journal, November 14, 1984, p. 3.

2. "David Stockman: No More Big Budget Cuts," Fortune, February 6, 1984, pp. 53-55.

3. For various poll results, see Advisory Commission on Intergovernmental Relations, 1983 Changing Public Attitudes on Government and Taxes, Washington, D.C., U.S.G.P.O., 1983; and German, Mark F., "Public Opinion Polls on Government Spending, Taxes and The Budget Deficit," Library of Congress, Congressional Research Service, March 20, 1984.

4. U.S. Department of the Treasury, Internal Revenue Service, 1981 Statistics of Income, Individual Income Tax Returns, Washington, D.C., U.S.G.P.O., 1983, Table 3-3, pp. 80-82. This table shows that taxpayers at each income level pay widely different percentages of their incomes in taxes.

5. U.S. Congress, Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 1984-1989," Washington, D.C., U.S.G.P.O., November 9, 1984, Table 1, pp. 9-17.

6. Musgrave, Richard A., "Tax Reform -- 1981 and After" in Economic Choices: Studies in Tax/Fiscal Policy, Washington, D.C., Center for National Policy, 1982, p. 15.

7. U.S. Congress, Joint Committee on Taxation, op. cit, Table 2, pp. 18-23.

8. For details on earlier tax legislation, see Talley, Louis Alan, "Significant Federal Tax Legislation, 1970-1978," Library of Congress, Congressional Research Service, Report No. 79-207E, September 21, 1979.

9. U.S. Department of the Treasury, Internal Revenue Service, Statistics of Income Bulletin, Washington, D.C., U.S.G.P.O., Fall 1984, Table 3, pp. 72-73.

10. Data in this section are drawn from

Riley, Dorothea, "Individual Income Tax Returns: Selected Characteristics From the 1983 Taxpayer Usage Study," in U.S. Department of the Treasury, Internal Revenue Service, Statistics of Income Bulletin, Washington, D.C., U.S.G.P.O., Summer 1984, pp. 45-62;

Tax Notes, September 24, 1984, p. 1313; and

Wall Street Journal, October 3, 1984, p. 1.

11. U.S. Congress, Joint Economic Committee, Hearings on Fair Taxation, Washington, D.C., U.S.G.P.O., June 13 and 14, 1984.

12. Ibid.

13. U.S. Department of the Treasury, Internal Revenue Service, Income Tax Compliance Research: Estimates for 1973-1981, Washington, D.C., U.S.G.P.O., 1983, p. 9.

14. Ibid., p. 10.

15. See Louis Talley, op. cit.

16. Cooper, Richard N., "Overtaxed by Tax Revision," New York Times, September 10, 1984, p. A-21.

17. Ibid.

18. For a more thorough explanation of the Lifetime Income Tax, see Aaron, Henry J. and Galper, Harvey, "A Tax on Consumption, Bequests, and Gifts and Other Strategies for Reform," in Pechman, Joseph A., ed., Options for Tax Reform, The Brookings Institution, Washington, D.C., 1984, pp. 106-134.

19. Bosworth, Barry, Tax Incentives and Economic Growth, The Brookings Institution, Washington, D.C., 1984, pp. 182-183.

20. Bickley, James M., "National Sales Tax: Selected Policy Issues," Library of Congress, Congressional Research Service, Report No. 84-141E, August 17, 1984, p. 11.

21. Ibid., p. 30.

22. "Survey of Consumer Finances, 1983," Federal Reserve Bulletin, September 1984, p. 689.

23. Testimony of Joseph Minarik in U.S. Congress, Joint Economic Committee, Hearings on Fair Taxation, June 13 and 14, 1984.

24. According to the Joint Committee on Taxation, tax preferences reduced corporate income taxes by $75.2 billion

during Fiscal 1984, a sum greater than corporate tax receipts of $56.9 billion. See Joint Committee on Taxation, op. cit., p. 17.

25. McIntyre, Robert S., Corporate Income Taxes in the Reagan Years, Citizens for Tax Justice, Washington, D.C., 1984.

APPENDIX

COMPARISON OF MAJOR TAX REFORM PROPOSALS

| | Current Tax Law | Kemp-Kasten FAST Proposal | Bradley-Gephardt Fair Proposal | Treasury Proposal |
|---|---|---|---|---|
| TAX RATES | | | | |
| Tax Rates | 11% to 50% | 25% | 14%, 26%, 30% | 15%, 25%, 35% |
| EXEMPTIONS | | | | |
| Self, Spouse | $1,000 | $2,000 | $1,600 | $2,000 |
| Dependents | 1,000 | 2,000 | 1,000 | 2,000 |
| Elderly | 1,000 | 2,000 | 1,000 | Credit |
| Blind | 1,000 | 2,000 | 1,000 | Credit |
| PERSONAL DEDUCTIONS | | | | |
| Mortgage interest | Yes | Yes | Yes | Yes |
| Other Personal interest | Yes | No, except on education expenses | No | Yes, $5,000 limit |
| Property Taxes | Yes | Yes | Yes | No |
| State and Local Income Taxes | Yes | No | Yes | No |
| Other Local Taxes | Yes | No | No | No |
| Charitable Contributions | Yes | Yes | Yes | Yes(above 2% AGI) |
| Medical Expenses | Yes(Amount above 5% of Adjusted Gross Income) | Yes(Amount above 10% of AGI) | Yes(Amount above 10% of AGI) | Yes(Amount above 5% of AGI) |
| Two-Earner Deduction | Yes(10% of lower salary) | No | No | No |
| OTHER INDIVIDUAL ITEMS | | | | |
| Indexing Retained | Yes | Yes | No | Yes |
| Income Averaging | Yes | No | No | No |
| RETIREMENT | | | | |
| I.R.A. Earnings | Deferred tax | Deferred tax | Deferred tax | Deferred tax |
| I.R.A. Deductions | Yes | Yes | Yes | Yes |
| Keogh Earnings | Deferred tax | Deferred tax | Deferred tax | Deferred tax |
| Keogh Deductions | Yes | Yes | Yes | Yes |
| Corporate Pensions | Deferred tax | Deferred tax | Limited | ? |
| Social Security | Social Security benefit exemption for low- and moderate-income individuals | Taxation of Social Security benefits is eased over current law | Keeps benefit exemption for low- and moderate-income individuals | Keeps benefit exemption for low- and moderate-income individuals |
| INVESTMENTS | | | | |
| Maximum Capital Gains Rate | 20% | 19%, then 25% | 30% | 35% |
| Capital Gains Exclusion | 60% | 30%, then 0 | 0 | 0 |
| Capital Basis | Not indexed | Indexed | Not indexed | Indexed |
| Dividend Exclusion | $100/$200 | None | None | None |
| Homeowner Exclusion | Yes | Yes | Partial | ? |
| General Obligation Municipal Bonds | Not taxed | Not taxed | Not taxed | Not taxed |
| Other Municipal Bonds | Not taxed | Taxed | Taxed | Taxed |
| Alternative Minimum Tax | Yes | Retained | Repealed | Repealed |

| | Current Tax Law | Kemp-Kasten FAST Proposal | Bradley-Gephardt Fair Proposal | Treasury Proposal |
|---|---|---|---|---|
| DEPRECIATION | | | | |
| Investment Credit | 6% to 10% | None | None | None |
| Depreciation Method | Accelerated Cost Recovery System, which allows for faster write-offs of some assets | Keeps the Accelerated Cost Recovery System | Replaces the A.C.R.S. with longer depreciation periods; allows assets to be depreciated using the 250% declining balance method | Replaces A.C.R.S.; allows asset basis to be indexed for inflation |
| LOWER INCOME PROVISIONS | | | | |
| Earned Income Credit | Yes | Yes, modified | Retained | Retained |
| Child Care Credit | Yes | Repealed | Deduction | Deduction |
| Unemployment Compensation | Taxed over $12,000 | Taxed | Taxed | Taxed |
| Worker's Compensation | Not taxed | Not taxed | Not taxed | Taxed |
| EMPLOYER PROVIDED FRINGE BENEFITS | | | | |
| Health Insurance | Excluded | Benefits taxed | Included | Capped exclusic |
| Life Insurance | Excluded | Excluded | Included | Included |
| Other Statutory | Included | Included | Included | Included |

Source: Tax Notes

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